

**FINANCIAL SERVICES COMMISSION****Friday, April 15, 2005****Securities Industry Draft Bulletin: Monitoring and Surveillance of the Jamaican Stock Market - Standards to be met by Market Participants**

1.0 Introduction

The Securities Act (Conduct of Business) Regulations (“the COB”) has a number of provisions aimed at ensuring that the securities markets are fair and transparent and that investors are protected. Specifically, improper conduct, such as market manipulation and insider trading, is prohibited. In addition, regulation 9 of the COB requires that each licensee maintains standards to ensure fairness in the allocation of investment opportunities to clients and to ensure that illegal trading of securities is not carried out when the dealer is in possession of material information which has not yet been made public.

The significant increases in the levels of activity on the Jamaica Stock Exchange over the past three (3) years has taken place in an environment where regulatory surveillance has relied heavily upon manual systems for the monitoring of trading activities. This is in contrast to many developed marketplaces, which utilize electronic surveillance systems to monitor and analyse trade data in order to detect improper conduct. It has been observed that on exchanges in more developed markets, such as the New York Stock Exchange, highly sophisticated surveillance systems have assisted in uncovering high profile cases, in respect to market abuses.

Effective enforcement of the law is enhanced through the existence of a closely monitored environment where there is a strong likelihood that improper activities will be detected, investigated and penalized.

In the interest of sustainable growth and development of the local stock market, it is therefore incumbent upon all market participants and not only the regulators, to become even more vigilant in ensuring that the integrity of the market is preserved through the enforcement of rules and regulations.

To this end, the Financial Services Commission seeks to operate a framework for monitoring and surveillance of the Jamaican stock market wherein the activities of all

market participants, including issuers of securities/listed companies, market intermediaries and their employees, are monitored by not only regulators, but also through their own internal systems.

The roles and responsibilities in this regard include the documentation and enforcement of rules and procedures for trading and other market activity and the establishment and promotion of standards of ethical conduct by all participants, professionals and industry organizations.

As part of this collaborative framework, the FSC will continue to strengthen its monitoring and supervision capabilities and will be actively promoting investor education. The more aware and informed investors are of the potential for market abuses and conflicts of interest, the greater will be their insistence on proper conduct.

This document identifies conduct which is prohibited under the law and outlines the responsibilities of the various market constituents in adopting best practices and procedures aimed at effective enforcement of the law.

The consequences attached to improper conduct by an employee do not rest only with the employee, but penalties also exist for brokerage firms or listed companies which fail to establish systems to prevent wrong-doing. Each market participant should therefore develop a culture of compliance throughout its organization and should continually enhance this culture through education and training.

The contents of this document are not meant to be exhaustive and the obligation rests with each market participant to be fully conversant with the Securities Act and related regulations and to implement internal rules and codes of conduct to ensure that the company and its staff do not engage in improper and unlawful practices.

2.0 Background

¹Market manipulation and insider trading are activities which subvert the objectives and principles of securities regulation which include protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.

Sections 44-50 of the Securities Act prohibit manipulative conduct, while section 51 prohibits dealing in securities by insiders. Under section 8 (1) and the Third Schedule of the Financial Services Commission Act, whenever an institution, or any of its directors, employees or agents engage in practices which contravene the provisions of the Securities Act, that institution is subject to remedial action by the FSC.

¹ International Organization of Securities Commissions "IOSCO" objectives and principles of securities regulation

Not only do licensees have the responsibility to ensure adherence with the law, but organizations whose members come into possession of insider information, by virtue of their profession, such as the Jamaica Securities Dealers Association (JSDA), Institute of Chartered Accountants of Jamaica (“ICAJ”), Bar Association and institutional investor organizations such as Insurance companies, Mutual Funds and Pension Funds should play an active role in promoting ethical standards by:

- Formulating organizational rules, codes of conduct and internal procedures prohibiting the use and dissemination of information acquired during the conduct of their businesses. Prohibited activities would include insider trading by ‘front-running’ an institutional investor’s order, by an employee or insider of that institutional investor;
- Ensuring that these rules are binding on their members and the organizations should have the ability to apply effective sanctions for breaches thereof.

2.1 Manipulative conduct:

The perpetrators of improper or unlawful conduct are generally seeking to benefit either directly or indirectly from their actions and the objectives of manipulative activity² include:

- Directly influencing the price of the security thus creating a benefit or profit for the manipulator
- Influencing the price of a security underlying an index, portfolio or fund (such as a mutual fund, unit trust, pension fund)
- Influencing the accounts/balance sheet of an institutional investor
- Influencing the price of a security in connection with a merger or take-over
- Influencing or triggering the sale or acquisition of an asset
- Creating an impression of superior performance by a financial manager or advisor
- Influencing someone to subscribe for, purchase or sell assets or rights to assets, or abstain from doing so.

Examples of trading activity which represent breaches under the Securities Act are given below, with reference to the relevant sections of the Act. The examples provided do not represent an exhaustive list but provide market participants with an awareness of the types of behaviour which constitute unlawful and improper conduct.

² Adapted from the IOSCO Investigating and Prosecuting Market Manipulation, May 2000

<u>Conduct prohibited</u>	<u>Source of prohibition:</u>
<ul style="list-style-type: none"> ▪ <i>Wash sales</i> – a series of matched trades at increasingly higher prices where there is no genuine change in beneficial ownership and which is aimed at creating a misleading appearance of active trading ▪ <i>Improper matched orders</i> – transactions where both the buy and sell are entered at the same price and for the same quantity by different but colluding parties 	Section 44, Securities Act: <i>False trading and market rigging transactions</i>
<ul style="list-style-type: none"> ▪ <i>Advancing the bid</i> – increasing the bid of a security in order to increase its price ▪ <i>Pumping and dumping</i> – buying the stock at increasingly higher bids then selling it at the high price (mainly to retail clients) ▪ <i>Marking the close</i> – buying or selling securities at the close of the market in order to alter the closing price and create a false impression of the market demand 	Section 45, Securities Act: <i>Stock Market Manipulation</i>
<ul style="list-style-type: none"> ▪ <i>Dissemination of false or misleading information</i> in order to move the price of a security in a direction favourable to the position held or planned 	Section 46, Securities Act: <i>False and misleading statements</i>
<ul style="list-style-type: none"> ▪ <i>Abuse of customer orders</i> <ul style="list-style-type: none"> i. front-running (placing orders for the company or connected person ahead of a substantial client order) ii. client orders in general not receiving priority over principal orders iii. lack of fairness in allocating investment opportunities among clients ▪ <i>Churning of client accounts</i> – excessive trading of client discretionary accounts in order to earn higher fees 	First Schedule, Securities (Conduct of Business) Regulations: <i>Standards of Professional Conduct</i>

2.2 Insider Trading

Inside information is information which is material enough that, if made public, it would likely have an effect on the price of securities issued by an issuer to which the information relates.

Persons deemed to be insiders may include primary insiders³, such as directors, managers and employees of the issuer or persons providing professional service to the

³ Adopted from IOSCO Insider Trading, How Jurisdictions Regulate it, March 2003

issuer, such as accountants, consultants or lawyers. Persons may also be secondary insiders if such persons learn the information from a primary insider or some other person (includes tippees or persons who accidentally come across the information).

A person with inside information could be expected to trade successfully in the securities in question and make a profit or avoid losses.

<u>Conduct prohibited</u>	<u>Source of prohibition:</u>
<ul style="list-style-type: none"> ▪ Intentionally trading on the basis of information which the trader considers material and which is not generally known; the source of the information may generally be the issuer or persons connected with the issuer and the insider may be trading for his account or a third party's account or have another party conduct the trade on his behalf ▪ Intermediaries trading on behalf of an insider, knowing or reasonably expected to know, that the insider is breaking the law; ▪ Tipping by insiders when there is reasonable cause to believe that the person receiving the information will make use of the information for purpose of dealing or procuring another person to deal in securities; ▪ Causing or procuring any person to deal in securities when in possession of insider information 	Section 51, Securities Act: <i>Prohibition of dealings in securities by insiders</i>

3.0 Market Surveillance Standards for Market Stakeholders

An effective surveillance framework is dependent upon the full involvement of market stakeholders. These stakeholders are responsible for developing best practices within their organizations in order to monitor and deter market abuse. The FSC shall assess the policies and procedures instituted by the market stakeholders. Outlined below are the responsibilities of each market participant.

3.1 Recognized Exchanges

1. Establishment of electronic monitoring capabilities in order to track and analyse all trading of its broker members and provide alerts for unusual trading activity.
2. To complement the monitoring system, the recognized exchange has to maintain an efficiently functioning infrastructure to react promptly to unusual trading activity, market information or disclosure issues. This

includes trading halts or suspensions where warranted and timely analysis and dissemination of information reaching the exchange.

3. Enhancement of monitoring capabilities, inclusive of on-site examinations, as well as documentation of relevant surveillance policies and procedures to ensure compliance with all of the exchange's rules by members and listed companies
4. Establishment of a facility for timely cross-border (regional) information exchange and investigations of unusual trading activity involving cross-listed stocks
5. Responsiveness of the recognized exchange's disciplinary procedures as it relates to breaches of the Securities Act and of its own rules.

3.2 Member Brokers of Recognized Exchanges

1. Establish, maintain and enforce a system of supervision of activities of registered representatives and of connected persons to achieve compliance with applicable securities laws and regulations

This includes the establishment of written supervisory procedures which provide for:

- a. assignment of a specific supervisor to each registered representative (persons cannot be responsible for supervising themselves)
 - b. specific steps to be taken by each supervisor e.g. exception reports, trade reporting, automated systems being used
 - c. periodic review of the supervisory system – standard weekly or monthly reviews as well as unscheduled reviews in cases of potential misconduct
 - d. documentation of reviews
 - e. internal inspections of activities of traders, analysts and financial advisors
2. Establish written policies for the conduct of trading operations, including rules prohibiting unlawful and manipulative trading practices and insider trading. These practices may relate to trading by the brokerage company, its employees and clients. Brokers should be in a position to decline to execute transactions on behalf of clients if there is a suspicion of insider trading or manipulative conduct.
 3. Incorporation of policies into internal training programs.
 4. Establish procedures to review analyst reports and to monitor the impact on trading activity. Additionally, the trading positions taken by analysts and

traders for their personal and for the dealer's accounts should be reviewed in relation to stock recommendations.

5. Establishment of 'Chinese Walls' between the trading and investment banking/corporate banking arms of the organization. This includes procedures for restricting the flow of information within the organization and procedures for designating restricted securities and for monitoring trading by officers in the securities of companies for which the company is providing investment or corporate banking services
6. Establishment of procedures to ensure that all principal trading and trading by staff and directors of the firm are fully disclosed to the firm and to client counterparties;
7. Establishment of procedures to monitor trading conducted through other firms by company employees or connected parties;
8. Ensure the existence of audit trails for orders, quotes and trades;
9. Establishment of policies to ensure that conflict of interest does not exist where an analyst's compensation is concerned or where an analyst's objectivity may be questioned as he may be encouraged to provide positive recommendations of companies which are clients of the firm
10. Establishment of procedures to monitor all incoming and outgoing correspondence, client communication, including advertising and sales literature and internet communication.

3.3 Listed Companies

1. Continuous observance of disclosure rules issued by the relevant exchange and the FSC.
2. Companies should have systems to guard against insider trading. These would include restrictions relating to the trading of the company's shares and this should apply to Directors, senior management and other officers likely to have inside information.
3. The guarding against insider trading should also extend to trading by the company in another company's shares when an officer of the first company is in possession of material information and is seeking to benefit or have the company benefit from trading;

4. Companies may put in place rules limiting the trading of connected persons, including issuers, brokers or underwriters in special cases, such as an offering of the company's securities or in a share repurchase.
5. Companies should have internal procedures governing the communication of information inside the company, in order to control the access to and handling of sensitive information

4.0 FSC Role

In addition to its role of ensuring the involvement of other stakeholders, the FSC's own direct role in this monitoring framework includes:

1. enforcement, during its examination procedures, of licensee responsibility for the establishment of rules and best practices governing the conduct of relevant market participants
2. continuous improvement in its capability as it relates to the direct surveillance of the trading of equities
3. leading training efforts and developing market awareness.

The goals of this multifaceted approach are:

1. achievement of comprehensive and cost effective monitoring of the market with minimal duplication of effort. Direct surveillance of all aspects of the market by both the FSC and the JSE is likely to prove very costly.
2. Containment of transaction costs and risk while maintaining and enhancing liquidity and transparency. In the small local market, a significant surveillance cost will serve to drive up transaction costs without necessarily having an appreciable effect on risk and transparency.
3. Involvement of all market stakeholders at all levels and development of a culture of compliance and promotion of high ethical standards within the industry.
4. Preservation of market integrity, fairness, transparency and protection of investors.

The FSC invites comments and suggestions from interested parties regarding the contents of this document. The deadline for submission is **June 3, 2005**. Please direct your comments to:

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